While stand-alone cost is the right starting point, it is extreme as an ending point because it does not include a share of common cost. Dr. Johnson explains, through an example, how the Joint Cost rules might incorporate a share of common cost in the telephone-OVS context:

> Under the joint-cost rules, each service is assigned its "attributable" cost (as a proxy for incremental cost) plus a share of common cost. After the costs attributable to each service in question are estimated, common costs are allocated to each service in proportion to directly attributable costs. Thus, if the costs attributable to OVS are $25 and those attributable to telephony are $50, OVS would be assigned one-third of the common cost. Consequently, any underspecification of OVS attributable cost would have a double effect on cost allocations. Not only would the assigned attributable or incremental cost of OVS fall below the true level, but the common costs of OVS would fall as well.[20]

The prospect of this double effect means that effective cost allocation procedures are particularly important. Without effective cost allocation procedures, LECs may be successful in underspecifying the costs attributable to OVS, with the remainder assigned to the telephone side.

To prevent this from happening, the Commission must not accept the LECs' rate proposals at face value. Rather, the agency should adopt in the pending rulemaking a cost allocation procedure requiring that an appropriate share of common cost in OVS rates. Employing this procedure, the Commission should verify in each individual case that the cost assignment to telephony is appropriate. Unless the cost (incremental and common) of the telephone component of the integrated facility is appropriately determined, telephone ratepayers will be subsidizing open video service.[21]

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[20] Id. at 11 (citation omitted).

[21] One possibly might be to require a LEC wishing to install a combined video-telephone platform to estimate the saving in total cost (for the combined system versus two stand-alone systems) and to reduce telephone rates by the same percentage as the overall percentage cost reduction.

B. Joint Marketing

The Commission recognizes that open video system operators "may wish to offer bundled packages of local and long-distance telephone service, video programming delivery, and data transmission over integrated networks."[22] There are obvious benefits from "one-stop shopping." When local telephone service, long distance, video programming and other services are available to consumers through a single contact, they are able to arrange for each service simultaneously.

Consumers, however, may wish to obtain these services from different suppliers on an unbundled basis, and they should have that choice. If consumers want to continue to obtain local telephone service from the incumbent LEC, and video programming services from the incumbent cable operator, for example, there is no policy justification for standing in their way. At the same time, there should be no prohibition against the institution of marketing inducements to encourage consumers to purchase bundled packages of services.

Special considerations arise, however, if the incumbent LEC attempts to market bundled local telephone service and video programming services. The incumbent LEC occupies a unique competitive position in the marketing of adjacent services.[23] When a person arrives in a new community or moves within their existing community (a increasingly common occurrence in our mobile society), the first call is generally made to "the telephone company" to arrange for that *essential* service. If at that time the telephone company representative, either directly or through a referral, exclusively recommends the incumbent LEC's cable or OVS service, the LEC will

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[22] Open Video Systems at 26

[23] CFA/NCTA Joint Petition for Rulemaking, RM-8221, Public Notice, Apr. 22, 1993.

achieve an unfair marketing advantage deriving exclusively from its position as the monopoly supplier of local telephone service. The new telephone customer might even be induced to purchase the LEC's video service without being aware of competitive alternatives.

Rather than encouraging this possibility, until telephone service is fully competitive, the Commission should institute an in-bound telemarketing process that levels the competitive playing field. As a condition of certification, incumbent LECs should be required to comply with a Commission-established set of procedures. These procedures should require an incumbent LEC representative who, in response to a customer call requesting telephone service wishes to advise the customer of any available video programming services, to also provide the name, address and telephone number of the local cable operator. The incumbent LEC representative should be prohibited from directly referring the telephone customer to the company's OVS or video programming service. Until telephone service is effectively competitive, this transitional protection is necessary to ensure consumers a true choice among video programming service alternatives.

C. <u>Separate Subsidiary</u>

The Commission should require Bell Operating Companies and other incumbent Tier I LECs that offer open video service and video programming directly to subscribers over OVS, to offer the services through a structurally separate subsidiary. Structural separation is necessary to assist regulators in the policing of discrimination and cross-subsidy.

The Act makes clear that the Commission may use its existing authority to prescribe safeguards consistent with the public interest, convenience and necessity.[24] The Commission

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[24] 1996 Act, § 272 (f) (3).

has used its broad public interest mandate in the past to impose structural separation between the regulated transmission and unregulated information services offerings of the Bell companies[25] and of other telephone companies.[26] On similar grounds, the Commission should structurally separate the incumbent LEC's telephone operations and its OVS operations.

Structural separation is warranted because the incumbent LEC has strong incentives to misallocate costs associated with OVS to telephone services. If successful, these misallocations will facilitate the unjustified loading of costs onto telephone services resulting in increased charges for the relatively inelastic telephone service, and the corresponding decrease in the charge for the more competitive OVS service. The resulting cross-subsidy will unfairly advantage the competitive OVS operation at the expense of telephone subscribers and competing multichannel video programming distributors.

Accounting safeguards can only go so far in ameliorating the potential problem where physically integrated plant is involved. As Dr. Johnson explains:

> The separate affiliate requirement would help ensure that "hidden" transactions do not occur between the parent and affiliate -- e.g., employees of the parent "helping out" informally with some of the functions of OVS ventures, resulting in costs recorded by the parent rather than by the OVS venture. Thus, a separate affiliate would help to ensure that recurring operating expenses properly chargeable to OVS are not instead borne by the parent. More generally, separation would help to enforce the ground rules for cost allocations established in accordance with Part 64 procedures.[27]

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[25] See e.g., Second Computer Inquiry, 77 FCC 2d 384, recons. 84 FCC 2d 50, (1980), aff'd sub. nom. Computer & Communications Industry Ass'n v. FCC. 698 F.2d 198 (1982).

[26] Regulatory & Policy Problems Presented by the Interdependence of Computer & Communications Services & Facilities. 28 F.C.C. 2d 291 (1990) (Tentative Decision); 28 F.C.C. 2d 267 (1971) (Final Decision), aff'd in part sub nom. GTE Service Corp. v. FCC, 474 F.2d 724 (2d Cir. 1973), decision on remand, 40 F.C.C. 2d 29[illegible] (1973).

[27] Johnson Declaration at [illegible] 14.

Structural separation is particularly important here because certain telephone companies have previously announced plans to invest billions of dollars in integrated plant. With such huge sums potentially involved, the separate subsidiary tool is absolutely essential to aid in the detection of cost and resource misallocations.[28]

IV. NON-LECS SHOULD BE PERMITTED TO OFFER VIDEO PROGRAMMING OVER LEC OPEN VIDEO SYSTEMS AS WELL AS THEIR OWN

Pursuant to the Act, "A local exchange carrier may provide cable service to its cable service subscribers in its telephone service area through an open video system that complies with ... [Section 653 of the Act]."[29] This provision applies to incumbent LECs that choose to offer video programming over an open video system, rather than elect the option of obtaining a cable franchise But it equally applies to new entrants into the business of providing local exchange service.[30] They, too, qualify as LECs for purposes of the statute.

These new entrants may unequivocally include companies that provide cable television service pursuant to a local franchise. It would be contrary to the statute for the Commission to

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[28] Some may argue that the offering by a Bell Operating Company of video programming qualifies under Section 271 (g)(1)(A) as an "incidental interLATA service" and, as a result, is explicitly excluded from the Act's structural separation requirement. This is not true. Section 271 (h) directs the Commission to narrowly construe the "incidental interLATA" exception, and finds that the exception applies only to interLATA transmissions "incidental to" video programming. Satellite delivered video programming is an interLATA service. The satellite component of the transmission is central to the transmission; there is nothing "incidental" about it.

[29] 1996 Act, § 653 (a)(1).

[30] "The term 'local exchange carrier' means any person that is engaged in the provision of telephone exchange service or exchange access." Id., § 3(a) (44).

reach the conclusion that new entrant LECs are not entitled to seek certification under Section 653, just because they are now franchised cable operators.

The statute also provides that cable operators, and others, may qualify as OVS providers if the Commission concludes that their operation in this manner is in the public interest. The Commission should find non LEC cable operators qualified to provide OVS for several reasons. First, Congress has just found that OVS operation is a legitimate alternative scheme for the provision of video programming directly to subscribers. In reaching that conclusion, Congress balanced the benefits of a franchised cable operator against the benefits of reduced local regulation when the facilities provider cedes substantial editorial discretion over the programming carried on the system.

On competitive grounds alone, the Commission should provide non-LECs with the option of pursuing OVS. If there is something desirable about the OVS option to LECs that causes them to pursue this option, there may be some similar benefit to their non-LEC competitors. "Level playing field" principles should be embraced in this instance because, after all, the principal purpose of the OVS option is to advance competition and innovative ways of distributing programming.

Non-LECs should be given the option of OVS for an additional reason. If they voluntarily cede a significant portion of their capacity to others, the same "multiple distributor" benefits deriving from LEC-delivered OVS would be present. While we believe that there are major consumer benefits to the cable operator's exercise of editorial discretion over its system's channels, there may be potential policy advantages to the OVS arrangement. If a cable operator, or indeed a new entrant that presently offers neither cable service nor telephone service decides to follow the OVS route, the Commission should not stand in its way.

While the Commission has been granted considerable flexibility to implement OVS, the scope of the agency's discretion does not permit the exclusion of cable operators from the LEC's OVS system. The Commission asks, "in light of subsection 653(b)(1)'s general prohibition on discrimination among video programming providers, the extent to which open video system operators would have discretion regarding the identity of video programming providers entitled to carriage on its system."[31] In other words, does the Conference Report language expressing Congress' intent to permit open video system operators to "tailor services to meet the unique competitive and consumer needs of individual markets"[32] authorize exclusion of a cable operator from capacity on an open video systems? The answer is no.

First, it is a settled rule of construction that the express language of the statute overcomes any potentially contrary legislative history. The statute unequivocally prohibits "an operator of an open video system from discriminating among video programming providers with regard to carriage on its open video system."[33] This language is not qualified in any way. Since a cable operator seeking capacity on an open video system would be "among the video programming providers" seeking "carriage on ... [the LEC's] open video system," discrimination against the cable operator by excluding it from the facility is prohibited.

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[31] Open Video Systems at 9.

[32] Id., citing Conference Report at 177.

[33] 1996 Act, § 653 (b)(1)(A).

In addition, there is nothing in either the statutory language or the legislative history to suggest that Congress intended for the OVS operator to exercise editorial control over more than the one-third of the capacity to which it is expressly entitled, except where excess capacity is available. The Conference Report language does not say, for example, that an OVS operator may exercise editorial control over more than one-third of the available channels if it is able to demonstrate that doing so will serve "unique competitive and consumer needs of individual markets." It certainly does not suggest that there are any reasons for the adoption of a new cross-ownership rule.

The Telecommunications Act took a major step in the direction of solving this perceived problem. It grants LECs the right to program their networks as cable operators under Title VI. It also gives LECs, and others who might want to operate open video systems, a guarantee of one-third of the system's channel capacity. With that level of control, not available to operators of video dialtone systems, OVS operators will be able to "tailor services to meet the unique competitive and consumer needs of individual markets." Any further allocation of capacity or control to the OVS operator will constitute discrimination under the statute.

The Commission should not bar local cable operators from obtaining OVS capacity. The OVS model is designed to promote not only competition to cable incumbents (and, we assume, DBS, MMDS, SMATVs and others), but also to provide for competition to the OVS operator on its facility. That, presumably, is a large justification for the OVS model. The incumbent cable operator is an obvious potential user of (and competitor to) the OVS operator. To exclude the cable operator by rule at the outset would diminish potential competition, and could defeat one of the best hopes for making OVS a workable model over which multiple programmers deliver video programming directly to subscribers.

V. THE COMMISSION SHOULD APPLY TITLE VI PROVISIONS TO OPEN VIDEO SYSTEMS IN A STRAIGHT-FORWARD MANNER

In establishing the OVS option, Congress expressly relieved system operators of the requirement to obtain a local cable franchise, and certain of the obligations, such as franchise renewals and compliance with most local requirements, that follow directly from the franchise requirement. OVS operators, in addition, are not subject to commercial leased access obligations, local rate regulation (except for the prohibition against negative option billing), and locally imposed customer service requirements.

OVS operators are, however, required to abide by several Cable Act provisions. Among these are must carry requirements for commercial and public television stations, retransmission consent, and ownership restrictions. Program access, negative option billing, subscriber privacy and equal employment opportunity regulation also apply. The Commission's certification procedure should be used to ensure that OVS operators are fully complying with the relevant Cable Act provisions.

A. Must Carry and Retransmission Consent

Congress' plain intent is to mandate a must carry/retransmission consent regime for OVS that is as similar as possible to the scheme that applies to traditional cable operators, to ensure that programmers employing the OVS facility do not escape from these obligations, and to guarantee broadcasters must carry/retransmission consent status (and PEG access for localities that seek it). This direction is straight-forward.

The must carry/retransmission consent provisions mean that the OVS operation must contain the equivalent of a tier of channels, including local broadcast and PEG channels, that all subscribers must purchase and "buy-through" to reach other programming on the system. The OVS operator's programming package must contain, at a minimum, the must carry channels. Similarly, any other packagers, except for part-time users, that purchase capacity must carry the local broadcast and PEG channels.

The Commission asks how must carry ought to be implemented in an environment of multiple packagers on the same facility. Should multiple packagers arise, the most practical solution would appear to be to classify the must carry channels as "shared," and to require all programmers to offer the must carry channels along with exclusive channels. This arrangement should not, of course, require subscribers purchasing multiple packages to pay for the must carry channels more than once. The subscriber should be permitted to choose the provider from which it will purchase the must carry channels. Once the subscriber makes this choice, it should be permitted to purchase programming from other packagers without being required to buy the other packagers' shared channels.

The Commission additionally seeks comment on the scope of must carry; i.e., which and how many channels, including low power stations, should receive must carry status. For purposes of this rulemaking, the Commission should apply the requirements of Section 614 and 615, and leave the particulars to the same process that is used to interpret statutory requirements for carriage of broadcast signals by traditional cable operators. Resolving must carry obligations in this way is sound policy and consistent with the Act's requirement that obligations on OVS should be "no greater or lesser" than on cable operators.

B. PEG Access

Open video systems are also subject to Section 611 of the Communications Act, 47 U.S.C. §531, which requires cable operators to provide local government with a local government channel for coverage of city council meetings and related matters, and an educational channel for use by local educational authorities, and a public access channel. PEG access channels, in the traditional cable context, are arranged for by the local franchising authority and the cable operator through the franchise negotiation process.

Section 611 of the Communications Act provides the procedure pursuant to which cable operators comply with PEG access requirements. Under the procedure, the franchising authority may establish PEG access obligations as part of an initial franchise negotiation or renewal. The franchising authority is given authority to enforce PEG access requirements that are contained in the franchise agreement. The cable operator generally is not permitted to exercise editorial control over any of the PEG access channels.

In contrast to the heavy involvement of local authorities in the regulation of traditional cable systems, the OVS model does not specifically contemplate any local role. But the absence of a local role in other aspects of OVS should not be interpreted by the Commission as undermining or eradicating the appropriate role of the local franchising authority in PEG access. Localities, not the FCC, are in the best position to deliver on the Act's intent to accomplish PEG access over open video systems.

The practical necessity of local franchising authority involvement in the implementation of PEG access on open video systems is consistent with the Act's admonition to "impose obligations that are no greater or lesser" than those imposed upon traditional cable operators.

The local franchising authority is the governmental entity best positioned to appreciate community needs and most experienced in the implementation of PEG access rules.

PEG access should be implemented through the channel administrator, on behalf of the system's programmers/packagers. The administrator should be authorized to enter into negotiations with the local franchising authority or a local access authority over the terms and conditions of providing PEG access over OVS systems. The channel administrator should be offered the same terms as those contained in the incumbent cable operator's franchise. Any variance from the terms contained in the franchise agreement must satisfy the Act's requirement that the obligations imposed are neither greater nor lesser than those imposed upon cable operators.

While the obligations imposed upon the OVS programmers and the incumbent cable operator should be as identical as possible, the cable operator should not be required to interconnect its channel feeds with those of the OVS operation. Nor should the Commission require the cable operator to otherwise share "capital and operating expenses related to PEG channels."[34] There is no legal basis to require the cable operator to interconnect its PEG channel feeds with anyone. (PEG access transmissions are not subject to common carrier requirements.) Unless voluntary interconnection agreements are reached between the parties, the OVS programmers will have to deliver PEG access independently.

[34] Open Video Systems at 24 (citation omitted).

C. Program Access

The Act applies the program access rules contained in Section 628 to open video systems. The provision is one of the elements of the new law designed to level the competitive playing field between traditional cable operators and open video systems. By applying the program access law to OVS, the Commission will comply with the plain meaning of the statute.

D. Other Title VI Provisions

The Act applies several other Cable Act provisions to OVS. Operators of open video systems must comply with Section 613 (ownership restrictions), exclusive of the MMDS/cable and SMATV/cable cross-ownership prohibition; Section 616 (carriage agreements); Section 623 (f) (negative option billing); Section 631 (subscriber privacy) and Section 634 (equal employment opportunity).

These provisions are easily understood and their implementation should not be controversial. The Commission should proceed to amend its rules to state simply that open video systems are subject to these requirements.

E. Franchise Fees

The Act permits a local franchising authority to impose a fee upon an OVS operator, akin to the franchise fee levied on cable operators pursuant to Section 622 of Title VI,[35] "on the gross receipts of the [OVS] operator for the provision of cable service."[36] This fee is be assessed on the basis of the gross revenues derived by the OVS operator on all of the channels, as well as the gross revenues derived by the OVS operator's video programming service. The fee may not

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[35] 47 U.S.C. § 542.

[36] 1996 Act, §653(c)(2)(B).

be assessed at a rate that is greater than the amount imposed upon the local cable operator. As with the local operator, the OVS operator may include the proportionate amount of the fee as a separate line item on the subscriber's bill.

This is straight-forward. This provision is one of the "level playing field" actions by Congress to require that OVS operators, to at least some extent, operate under the same rules as cable operators. It also requires OVS operators to compensate localities for the use of their streets when they provide the cable-similar (if not equivalent) OVS service.

VI. SPORTS EXCLUSIVITY, NETWORK NONDUPLICATION AND SYNDICATED EXCLUSIVITY SHOULD BE APPLIED TO OPEN VIDEO SYSTEMS

The Act further directs the Commission to adopt regulations that extend to the distribution of video programming over open video systems the Commission's regulations concerning sports exclusivity (47 C.F.R. §76.67), network nonduplication (Id., §§76.92 et seq.) and syndicated exclusivity (Id., §§76.151 et seq.).

The Commission asks how these provisions ought to be applied to OVS, and notes that the issue is complicated because the programming on these channels are likely to be shared by multiple users of the OVS facility. The solution is to give the responsibility for implementation to the channel administrator which, under the proposal described above, will be selected collectively by the programmers using the system. The channel administrator will be in the best position to track schedules to determine when the display of particular programming by any of the programmers on the system will violate the exclusivity rights exercised by broadcasters. The channel administrator should be empowered to block the required programming on shared channels and thereby to prevent its display. For the exclusive channels, the first responsibility for blocking should be left to the particular packager leasing the channel, although the actual blocking function might be performed by the channel administrator for a fee.

VII. AN EFFECTIVE CERTIFICATION PROCESS IS ABSOLUTELY ESSENTIAL

The Act provides that prior to commencing service, an OVS operator must certify that it is in compliance with the Commission's regulations. The Commission is directed, pursuant to Section 653(a) (1), to approve or disapprove certification requests within ten days of their receipt.

The statute makes clear that the purpose of the certification process is to provide a vehicle through which the Commission may determine whether particular OVS operator proposals comply with the regulations. There is no suggestion in the statute or legislative history that a certification request carries with it any presumption of validity. Rather, following public notice, the Commission is directed to "approve or disapprove" certification requests.

The Commission asks "whether it would be consistent with the 1996 Act to establish a review process that only would make a determination that the application is facially proper, subject to a more thorough review if a dispute subsequently arises regarding compliance with the open video system provisions."[37] The Act does not permit this approach. It requires a finding, based upon the operator's showing, of whether the operator "complies with the Commission's regulations."[38]

The Commission is properly concerned that ten days is an insufficient period to evaluate compliance. It suggests that the OVS operator should be required to file basic information,

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[37] Open Video Systems at 27

[38] 1996 Act, §653(a)(1).

presumably subject to staff evaluation, as a <u>prerequisite</u> to the filing of certificates. This procedure will give the staff an opportunity to evaluate whether the submitted information is sufficient to demonstrate compliance, and, where necessary, to communicate potential deficiencies. This approach is far better than an arrangement in which the Commission is forced to initially reject certification requests because of an operator's failure to file necessary information.

Pre-filed information should include, and applications for certification should demonstrate at a minimum, that the operator's plans in the following areas warrant approval:

- ✔ A demonstration that the operator's plan for allocating integrated system costs between telephone service and OVS has been approved by the Commission;
- ✔ A demonstration that the operator has either established or intends to establish a separate subsidiary that complies with the Commission's regulations;
- ✔ The number of analog and digital channels that the operator proposes to offer when service commences;
- ✔ The operator's plan for offering two-thirds of the activated channels on a nondiscriminatory basis, including an "open enrollment" procedure that complies with the Commission's procedures;
- ✔ The operator's proposal, if any, to provide the technical capability for the sharing of channels;
- ✔ A demonstration that the operator intends to enter into an agreement for the joint administration of shared channels, including must carry and PEG channels, or for channel administration by a channel administrator collectively chosen by all of the programmers;
- ✔ A demonstration that the rates, terms and conditions under which it proposes to offer service are just and reasonable, and are not unjustly or unreasonably discriminatory;
- ✔ A demonstration that the operator has adopted a procedure whereby, if its telephone affiliate informs customers of the affiliated OVS or video

programming service, it will simultaneously and without favor inform customers of competitive alternatives;

- ✔ A demonstration that the operator is either in compliance with, or intends to comply, with Cable Act provisions relating to must carry, retransmission consent, PEG access, program access and other matters; and

- ✔ A demonstration that the operator is in compliance with, or intends to comply, with Commission regulations regarding network nonduplication, syndicated exclusivity and sports exclusivity

Based upon a review of this basic information, the Commission can determine whether to grant an OVS operator's request for certification.

The Commission's work is not over once it authorizes a certificate. In accordance with the "dispute resolution" procedure provided for at Section 653(a)(2),[39] the Commission should stand ready to resolve complaints brought by interested parties or by the Commission's on its own motion in an expeditious manner.

VIII. <u>PETITION FOR RECONSIDERATION</u>

The Commission, in a <u>Report and Order</u> accompanying the <u>NPRM</u>, takes several actions that are intended to conform the agency rules to the legislation. Because the Act repeals Section 613(b), the telephone/cable cross-ownership bar, the Commission removes the implementing regulations from the Code of Federal Regulations. The Act also eliminates the requirement that local telephone companies obtain the Commission's prior approval before constructing or operating video capable facilities. Finally, the Act terminates and vitiates CC Docket No. 87-266, the video dialtone proceeding, but directs that the new law "shall not be construed to

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[39] <u>Id</u>. at §653(a)(2).

require the termination of any video-dialtone system that the Commission has approved before the date of enactment of this Act."[40]

The Commission's elimination of accounting and reporting requirements established for the provision of video programming over common carrier transmission facilities, while not a part of CC Docket No. 87-266, follows directly from the elimination of the video dialtone regulations. The Commission errs, however, when it does not "require currently approved video dialtone systems to cease operations"[41] and offers no explanation for this ruling. Congress did not *"require"* the termination of existing authorizations, but it does not constrain *the Commission's discretion* to order termination. The agency should do just that, following a reasonable transition period.

Congress could have grandfathered existing authorizations. However, it did not. Accordingly, the outstanding video dialtone trials that were authorized to operate only until a date certain should terminate on those dates. If the companies currently offering service pursuant to these authorizations wish to continue operations, they should seek either a local cable franchise or an OVS certificate.

Trials in which the offering of service has not yet commenced, and commercial authorizations, should be required, after some reasonable transition, to choose between OVS and franchised cable service. With the termination of the video dialtone proceeding, there are no longer any video dialtone rules. Since the Commission surely does not intend the complete deregulation of these systems without any public interest finding that deregulation is

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40 Open Video Systems at 30 citing 1996 Act § 302 (b)(3).

41 Id. at 30.

appropriate, the only choices are to conduct a rulemaking to consider the establishment of new rules for these few systems, or to require that they select between OVS and franchise operation. The latter choice is the preferable alternative.

CONCLUSION

OVS allows companies, in exchange for ceding a degree of editorial control, to avoid the local franchising process. In return, they must offer nondiscriminatory access to nonaffiliates on up to two-thirds of their channel capacity.

Having chosen the OVS route, operators may be inclined to discourage unaffiliated programmers--their competitors--from pursuing the business opportunity that the statute plainly contemplates. If unaffiliated programmers can be persuaded that they have no real business chance to compete with an OVS operator's programming package, the operator will achieve the best of both worlds: a monopoly on its facility, with no local oversight and few of the local responsibilities of franchised cable operators.

It is up to the Commission to see that this does not happen. It is the Commission's responsibility to enforce real nondiscriminatory access, to implement effective cost allocation rules, to adopt structural and non-structural competitive safeguards, to protect the rights of programmers, and to more generally protect consumers and competition in the process. It is also up to the Commission to implement a certification process that makes this all come about in individual cases.

Respectfully submitted,

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April 1, 1996

ATTACHMENT A

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of Section 302 of the Telecommunications Act of 1996	)	CS Docket No. 96-46
	)	
Open Video Systems	)	

DECLARATION OF LELAND L. JOHNSON, Ph.D.

I, Leland L. Johnson declare the following:

I am a consultant in telecommunications economics residing in Woodland Hills, California. I retired in March 1993 from the RAND Corporation, Santa Monica, California, where I had been employed, with two interruptions for government service, since 1957. I received my Ph.D. in Economics from Yale University in 1957. During 1978-1979, I was Associate Administrator for Policy Analysis and Development in the National Telecommunications and Information Administration in Washington D.C. During 1967-1968, I was Research Director of the President's Task Force on Communications Policy in Washington. In these capacities, I have written widely on issues of monopoly and competition, government regulation, and appropriate public policy. In recent years, I have focused on telephone company entry into video, including effects of advances in fiber optics and other technologies, and the economic implications of providing telephone and video services over integrated transmission facilities. I have presented numerous seminars and briefings, and have testified before Congressional subcommittees and government administrative agencies. I am author of the book *Toward Competition in Cable Television* (MIT Press and AEI Press), published in 1994. An attached resume describes my background in further detail.

I have been asked by the National Cable Television Association to evaluate the potential for cross-subsidization inherent in the open video system ("OVS") approach for entry by local exchange carriers into the video marketplace, as specified in the Telecommunications Act of 1996 ("Act"). This task follows my extensive participation in Commission proceedings involving filings by local exchange carriers for video dialtone service.

<u>The Threat of Cross-Subsidization</u>

The danger of cross-subsidization exists regardless of the form in which the LEC seeks to enter the video market. Whether a LEC previously sought entry under the rules and policies governing video dialtone, or whether it now seeks entry via the OVS route -- or, for that matter, seeks entry as a cable operator -- the LEC may be severely tempted to underprice its competitive video offerings at the expense of its monopoly basic telephone ratepayers, most notably residential and small business customers. Establishment of safeguards against this threat is all the more pressing in light of the stricture in the 1996 Act: "A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition."[1] As discussed below, appropriate safeguards include close Commission supervision of cost allocations between the LEC's telephone and OVS services, and establishment of a separate subsidiary for OVS services.

[1] 1996 Act, Sec. 254(k).

As demonstrated in previous LEC proposals for video dialtone, the threat of cross-subsidization looms most clearly when the LEC endeavors to build a broadband facility for both video and voice, and seeks to charge off the bulk of the investment to telephony, despite the existence of today's well-functioning telephone networks. For example, prior to the time Pacific Bell drastically scaled back its plans for video dialtone,[2] the company had proposed to allocate to telephony 85 percent of its proposed investment in hybrid fiber-coaxial networks in four California metropolitan areas, despite any sound showing that the new networks were needed to replace its existing telephone facilities.[3] Similarly, for Bell Atlantic's video dialtone service in Dover Township, New Jersey, the company filed a tariff in 1995 based on charging off two-thirds of the network investment to telephony, again with no sound showing of why the new network was needed to replace existing telephone facilities. By shifting costs to telephony, video dialtone providers could offer below-cost tariffs to program providers as a way to undercut cable operators and other facilities-based multi-channel video suppliers.

Consider a simple illustration of this phenomenon. Suppose that the broadband network for both telephone and video service costs $1,500 per home passed, while a stand-alone telephone network for the same telephone services costs $700. In this case, the incremental cost, or the cost "caused" by video is $800, since this is the additional cost required for a network that carries video as well as telephony. If the LEC assigns anything more than $700 of the $1,500 total to telephony, telephone customers will be burdened with more than the cost required to serve them, while video would cover less than its incremental cost. If, for example, $900 were charged to

[2]For an interesting account of these cutbacks and the technical and other problems that caused them, see "Pac Bell Pulls Plug on High-Tech Project," *Los Angeles Times* (Valley Edition), January 26, 1996 at p. A1.

[3]*Declaration of Leland L. Johnson*, W-P-C 6913, 6914, 6915, 6916, April 7, 1995, appended to Comments of the California Cable Television Association.

telephony, a subsidy of $200 [$900 - $700] would flow from telephony to video. Thus, to prevent cross-subsidy, the telephony stand-alone cost would constitute a ceiling for the cost allocated to telephony. In both the Bell Atlantic and Pacific Bell video dialtone applications, as well as others, the amounts proposed to be assigned to telephony were above telephony stand-alone costs, resulting in a disturbing threat of cross-subsidy.

Concern about cross-subsidization for OVS service arises on the same basis as for video dialtone. The OVS carrier may plan construction of a broadband system for telephony and video and, as before, propose that the bulk of costs be borne by telephony. The only notable difference from the video dialtone model is that the OVS provider would deal with "carriage charges," rather than with "tariffs," as a tool for undercutting competitors.

That this threat of cross-subsidization is far from a mere theoretical possibility is illustrated by the stunning chain of events involving Bell Atlantic's video dialtone tariff. The Commission permitted the tariff to go into effect in 1995,[4] but set the tariff for investigation. During the investigation, I concluded that because of the overassignment of investment to telephony, Bell Atlantic's tariff rates would have to be more than <u>doubled</u> to cover actual video dialtone incremental cost plus the share of common cost computed on the basis of the company's cost allocation methodology, while the rates would have to be increased by more than <u>75 percent</u> to cover video incremental cost alone.[5] With tariff rates covering only a portion of the level required to cover video dialtone incremental cost, it would hardly be surprising if programmers

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[4]Bell Atlantic *Tariff F.C.C. No. 10 Transmittal No. 741*, January 27, 1995.

[5]*Declaration of Leland L. Johnson* at 26-31, appended to *Opposition to Direct Case*, National Cable Television Association, Inc., In The Matter of Amendment to The Bell Atlantic Telephone Companies Tariff No. 10, Video Dialtone Service, November 30, 1995.